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COMMERCE FOR SECRETARY GUTIERREZ FROM AMBASSADOR STRUBLE

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SUBJECT: SECRETARY GUTIERREZ'S VISIT TO PERU - SCENESETTER

Sensitive But Unclassified, please handle accordingly.

¶1. (SBU) Mr. Secretary, I welcome your July 27-28 visit to participate in the inauguration of President-elect Alan GARCIA Perez. This presidential transition is historic--for the first time in modern Peruvian history one elected leader will transfer authority to another without the backdrop of an economic or political crisis. That notwithstanding, the close presidential election on June 4 showed a deep geographic fault line in Peru between the more prosperous coast and more backward mountain and jungle regions. Despite a strong economy, Peru suffers from a weak and fractured political system. U.S. engagement will be critical to the Garcia government's efforts to overcome political, economic and social challenges.

Strong Economic Growth and Macroeconomic Achievements

¶2. (U) The Garcia Administration will inherit one of the strongest economies in Latin America. The current expansion began in 2001, following the political crisis that ended the Fujimori Administration, and has gained momentum over the last several years. GDP growth in 2005, at 6.7 percent, was the fastest since 1997. The economic expansion has continued into this year, despite the uncertainty created by the presidential elections. Analysts recently began raising their estimates for growth in 2006 from 5 percent to 5.5-6 percent. The 12-month average growth ending in May was 6.5 percent.

¶3. (U) The strong growth has been propelled by increased private investment, an export boom (triggered initially by the Andean Drug Eradication and Trade Promotion Act (ATPDEA) and aided later by high mineral prices), prudent fiscal management, and, more recently, strong domestic consumption and construction. Exports will have tripled by the end of this year compared to when President Toledo took office, rising from \$7 billion in 2001 to an estimated \$21 billion. Minerals make up just over half the exports, but non-traditional goods like textiles, apparel and agricultural products have grown significantly.

¶4. (U) The sustained economic expansion and, in particular, the agricultural export boom, have led to a moderate but significant reduction in poverty. The poverty rate - those living on less than \$2 per day - declined from 54 percent in 2001 to an estimated 48 percent today. Extreme poverty -

those living on less than \$1 per day - declined more dramatically, from 24 percent to 18 percent, a 25 percent drop in four years. The areas that have seen the greatest reductions in poverty have been those participating in the agricultural export boom, (such as Ica where companies are reporting a labor shortage), and those that have been areas of focus for USAID programs. Analysts expect unemployment, underemployment and poverty to decline at a faster pace in the near-to-mid term as the expansion continues.

¶5. (U) Inflation has been tame despite the economic expansion, 1.5 percent in 2005 and an annualized rate of 2.5 percent in May 2006. The Toledo Administration wisely allocated some of its current account surplus to pay down the public debt, lowering the debt-to-GDP ratio from 50 percent to 38 percent. The federal government may have a small surplus in 2006, due to fiscal restraint, greater tax revenues generated by the economic expansion and increased efficiency in tax collection.

Despite Past Record, the Country Is Optimistic

¶6. (SBU) When Garcia was last elected President in 1985 at the age of 35, the government was weak, the terrorist war with the Shining Path was spreading, inflation was rampant, and the international debt burden was very high. Garcia's policy decisions made matters worse - he restricted international debt payments to 10 percent of exports earnings, attempted to nationalize Peruvian banks and insurance companies and launched large public works projects without adequate financing. By the end of his term, inflation had gone from 87 percent to 7,649 percent, per capita income had dropped to below the 1960 level, the GDP had fallen 20 percent, poverty had grown from 41 percent to 55 percent, and the Shining Path was staging attacks in the capital.

¶7. (SBU) Despite this record, the business community and the population as a whole continue to express confidence in Garcia's ability to manage the country and the economy during this second presidency. The President-elect understands that this confidence is tenuous. He has sent reassuring signals to the business community that he will respect contracts, show macroeconomic discipline, and welcome public-private partnerships for infrastructure needs. His center-left APRA party has intentionally tried to cast a wide embrace to bring in people from the center and center-right. Amongst Garcia's challenges as President will be keeping this informal coalition intact.

¶8. (U) Garcia's near term priorities include promoting agricultural modernization in the Andes through his "Sierra Exportadora" program and improving water quality and delivery. These programs should begin shortly after the inauguration, and if seen as credible, will help APRA leaders in the upcoming November regional and municipal elections. In the medium term, Garcia is looking to maintain macroeconomic growth while encouraging new investment.

Early Challenges

¶9. (SBU) The election results (52.6 percent for Garcia and 47.4 percent for leftist/nationalist Humala) show a clear fracturing of the vote between those areas that benefit from international commerce and those that have thus far been excluded from national and global markets. In the coming months, President-elect Alan Garcia will face greater pressure to strike a careful balance: to reassure foreign investors that his policies can sustain the current macroeconomic boom and improve Peru's investment climate, while winning over the pro-Humala opposition with tangible results of his poverty reduction policies. Specifically:

-- Garcia must implement a credible program to attack the

high levels of poverty.

-- Given that the Peru Trade Promotion Agreement (PTPA) has not been approved by the U.S. Congress, Garcia must assume full responsibility for ratification of an agreement negotiated by the outgoing government. The President-elect has tried to suggest that he could have gotten a better deal, but he realizes that PTPA is central to many of his proposed economic programs (e.g., "Sierra Exportadora.")

Issues That Garcia May Raise

¶10. (SBU) Garcia may raise with you:

-- His appreciation for President Bush's invitation to visit the White House on October 10.

-- His government's urgent focus on poverty and the desire for 1) increased U.S. assistance in linking sierra and jungle producers to international markets, and 2) increased assistance for priority initiatives like clean drinking water programs.

-- Concern regarding U.S. counter-narcotics assistance levels. Garcia believes there should be increased support from the U.S. and international donors. (Note: U.S. counter-narcotics aid in 2006 dipped slightly to \$108 million but remains twice as high as the average level during the 1990s. End Note.)

-- The role that the U.S. can play in helping build and maintain investor confidence in his administration.

Demographic/Political Overview

¶11. (U) Peru is a country of 27.2 million people, of whom 30 percent live in the Lima/Callao metropolitan area. Most Peruvians are either Amerindians (45 percent, largely Quechua-speaking but also many Amazon languages) or Spanish-speaking mestizos (37 percent, a mixture of indigenous and European roots). The remainder of the population includes persons of European (15 percent), African, Japanese, and Chinese ancestry. Peru's distinct geographical regions are mirrored in a socioeconomic divide between the coast's mestizo-Hispanic culture and the more diverse, traditional cultures of the highlands and jungle area.

¶12. (SBU) Twenty-four candidates competed in the first round presidential elections on April 9, and the two top vote-getters, Garcia of the APRA party and Ollanta Humala of the Union for Peru (UPP) party, faced off in a June 4 runoff. This runoff offered voters a clear choice between two quite different alternatives. Garcia stood for the continuation of policies that brought Peru nearly five years of five percent annual economic growth, respect for human rights, job creation and poverty reduction through market-based economic growth, and good relations with the U.S. Humala, an ally of Venezuelan President Chavez and Bolivian President Morales, advanced policies that resemble theirs: a stronger executive promoting state intervention in the economy, suspicion of foreign trade and investment, and populist social programs. Garcia, who placed second in the first round, won the runoff election with a 5.2 percent spread.

¶13. (SBU) The new 120-member Congress elected on April 9 consists of seven parties. Humala's UPP party currently controls over a third of the seats. (Note: The UPP congressional caucus has shown signs of fracturing into smaller groups. End Note.) The APRA has the second largest block with just under a third of the seats. The fragmented nature of the incoming Congress will be another challenge for the Garcia Administration.

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